

EFFECT OF POTENTIAL TAX CHANGES ON SIS OFFICERS

SIS UPDATE

REFERENCE: EB 1323, dated 26 December 1985

1. The referenced Employee Bulletin provided models of how proposed tax reform legislation in Congress could affect GS-11 and GS-15 annuitants. We thought it would be useful to provide examples of how the proposed tax law change would apply to the unique circumstances of Senior Intelligence Service officers who generally have higher annuities and lump-sum leave payments. Several examples of the potential tax impact are shown in paragraph 5 below.

2. The tax legislation proposed by the House would eliminate the present "three-year rule" that grants to retirees an initial tax-free period while they recover their retirement contributions. For most government employees this tax-free period is usually approximately 18 months. The "three-year rule" would be replaced by a "general rule" which would require that recovery of retirement contributions be prorated over the life expectancy of the annuitant. The "general rule" would result in a significantly higher tax liability over the first two years of retirement, although the "three-year rule" would cost more in taxes over the long run.

3. While the elimination of the "three-year rule" potentially would have a dramatic impact on annuities, it is still very uncertain what will ultimately be enacted on this issue. The current House-passed proposal would make the provision on taxing annuities effective for annuities starting after 1 July 1986. The Senate, on the other hand, is only beginning to take up the tax issue, but their stated intention is to completely rewrite the House version. There has also been a resolution introduced in the Senate to eliminate entirely the House changes on taxing annuities.

4. Agency management also recognizes that this could be a troublesome area and has expressed concern to Congress on the proposed changes. In responding to Congressman Frank Wolf's specific inquiries, the Director of Personnel pointed out, in remarks recently quoted in the Washington Post, that employees are keenly aware of this issue and that experienced officers,

who would otherwise not be leaving, would retire to avoid this change. The Senate has also asked for Agency input on the potential negative impact of such legislation, as it prepares to address the tax reform issue.

5. The following are three hypothetical SIS retirement examples along with assumptions made in developing the data:

Assumptions:

- a. Retire on 1 January 1987.
- b. Accumulation of 1000 hours of annual leave; lump-sum-payment received in the first year of retirement.
- c. Married and files jointly for tax purposes.
- d. Spouse is the same age.
- e. A 4% cost-of-living adjustment per year.
- f. No other income or excess itemized deductions for tax purposes.
- g. Self and spouse are only eligible for one personal exemption each, and one additional exemption each after reaching age 65.
- h. No other changes to current tax laws.
- i. Examples based on SIS-3 with final salary of \$68,700.

Example 1: Age 50 with 25 years of service. Remaining life expectancy is 30 years. Beginning annuity is \$32,600 per year.

Tax Year	Tax Liability		Difference	Cumulative Difference
	General Rule	Three-Year Rule		
1987	15,583	4,937	10,646	10,646
1988	4,749	1,631	3,118	13,764
2013	25,075	25,760	(685)	(643)
2016	30,024	30,750	(726)	(2,539)

During the first two years, the "three-year rule" saves the taxpayer \$13,764 over the "general rule". After 27 years, the cumulative tax paid under the "three-year rule" begins to exceed that paid under the "general rule". By the end of 30 years, the "three-year rule" has cost a total of \$2,539 more than the "general rule".

Example 2: Age 55 with 30 years service. Remaining life expectancy is 25 years. Beginning annuity is \$38,000 per year.

<u>Tax Year</u>	<u>Tax Liability</u>		<u>Difference</u>	<u>Cumulative Difference</u>
	<u>General Rule</u>	<u>Three-Year Rule</u>		
1987	17,476	4,937	12,539	12,539
1988	6,051	2,113	3,938	16,477
2008	23,023	23,975	(952)	(687)
2011	27,577	28,599	(1,022)	(3,614)

During the first two years, the "three-year rule" saves the taxpayer \$16,477 over the "general rule". After 22 years, the cumulative tax paid under the "three-year rule" begins to exceed that paid under the "general rule". By the end of 25 years, the "three-year rule" has cost the taxpayer a total of \$3,614 more than the "general rule".

Example 3: Age 60 with 35 years of service. Remaining life expectancy is 20 years. Beginning annuity is \$44,500 per year.

<u>Tax Year</u>	<u>Tax Liability</u>		<u>Difference</u>	<u>Cumulative Difference</u>
	<u>General Rule</u>	<u>Three-Year Rule</u>		
1987	19,846	4,937	14,909	14,909
1988	7,929	2,797	5,132	20,041
2004	22,815	24,217	(1,402)	(719)
2006	25,790	27,203	(1,413)	(3,534)

During the first two years, the "three-year rule" saves the taxpayer \$20,041 over the "general rule". After 18 years, the cumulative tax paid under the "three-year rule" begins to exceed that paid under the "general rule". After 20 years, the "three-year rule" has cost a total of \$3,534 more than the "general rule".

6. The above examples are provided as guidelines only, and should not be used to replace the specific circumstances of an SIS officer. SISers are urged to retain their own tax advisors who can provide the best advise on individual situations. While the outcome of this legislation is uncertain, the Offices of Personnel and Congressional Affairs are continually monitoring its progress. We will continue to keep employees as current as possible on this important issue so that employees may have the maximum information available on which to make decisions related to retirement.